No. 11,912

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

THE DAVENPORT FOUNDATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF ON BEHALF OF PETITIONER.

MELVIN D. WILSON,
819 Title Insurance Building, Los Angeles 13,
Counsel for Petitioner.

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BRIEF ON BEHALF OF PETITIONER.

Statement of the Case.

This case comes before the Court on a petition for a review of a decision and order of The Tax Court of the United States determining deficiencies in the Federal taxes of petitioner, as follows:

Year	Income Tax	Declared Value Excess-Profits Tax
1940	$ 468.02	$ ———
1941	1,415.13	409.20
1942	2,292.63	300.11
1943	2,272.00	86.30
1944	2,804.44	———

Question Involved.

The question involved is whether petitioner was exempt from Federal corporate income tax for the years 1940 to 1944, inclusive, and declared value excess profits tax, for the years 1941 to 1943, inclusive, under the provisions of Section 101(6) and Sections 600, 1200, 1201(a)(1) of the Internal Revenue Code, or in the alternative under the provisions of Section 101(14) and Sections 600, 1200, 1201(a)(1) of the Internal Revenue Code.

The petitioner contends, (1) that it was exempt for the years mentioned above, as it was a corporation organized and operated exclusively for religious, charitable or educational purposes, no part of the net earnings of which inured to the benefit of any private shareholder or individuel and no substantial part of the activities of which was carrying on propaganda or otherwise attempting to influence legislation, or (2) in the alternative, was exempt as it was a corporation organized for the exclusive purpose of holding title to property, collecting income therefrom and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from income tax.

The respondent contends that a substantial part of petitioner's income inured to the benefit of private individuals, or in the alternative, that not all of petitioner's income was turned over to organizations which themselves were exempt from income tax, and hence the petitioner was not exempt from income or declared value excess profits tax.

The Tax Court denied the petitioner's contentions, and held that it was not exempt from income and declared value excess profits tax.

Statement.

The facts are not in dispute as written and documentary evidence was introduced as joint exhibits by the respective parties and the respondent introduced no oral testimony.

Petitioner was incorporated July 8, 1940 under the laws of California as a non-profit corporation [Tr. 75], for the stated purpose "To act as Trustee under Christian Educational, Charitable, Eleemosynary, and other charitable trusts" [Tr. 114]. Specifically, petitioner was to replace LaVerne College as trustee of a trust created on May 23, 1939 by Levi M. Davenport [Tr. 58]. On September 5, 1940 the Board of Trustees of the trust, also called The Davenport Foundation, adopted a resolution which provided that all of the property in the trust created by Levi M. Davenport was to be transferred to The Davenport Foundation, a corporation, subject to the terms of the declaration of trust and that the acceptance of the assets by the corporation was to be a recognition of the fact that the assets so transferred were subject to and accepted by the corporation subject to the terms and provisions of the declaration of trust [Tr. 135-6]. Petitioner's Articles of Incorporation [Tr. 120], and its By-Laws, provided that vacancies on the Board of Directors should be filled from persons having qualifications specified in the said trust created by Levi M. Davenport on May 23, 1939.

On May 23, 1939, Levi M. Davenport executed an irrevocable transfer in trust of substantially all of his real and personal property [Tr. 34], to LaVerne College, a corporation, as trustee with Davis, Weller, Steinour, Flora & Miller as the Board of Trustees of the trust [Tr. 84-97]. On the same day the Board of Trustees adopted

by-laws for the trust [Tr. 98-108]. Also on May 23, 1939 Levi M. Davepnort transferred to the trust, subject to certain reservations and exceptions, property having a value of $261,884.00 [Tr. 76]. On June 1, 1939 Barbara N. Davenport, wife of Levi M. Davenport, transferred to the trust, subject to certain reservations, two parcels of real estate having a value of $8,500.00 [Tr. 78, 108 to 110, incl.].

The trust established by Levi M. Davenport and his wife was created for religious, charitable and educational purposes. The management of the trust was vested in a Board of Trustees which was subject to the control of the Elders Body of the Church of the Brethren of the District of Southern California and Arizona. Members of the Board of Trustees were required to be persons who subscribed to certain fundamental religious doctrines set forth in the declaration of trust [Tr. 84-97].

Certain reservations were made from the transfers of property to the trust. $400.00 per month was reserved to Levi M. Davenport for his life. He also reserved for his lifetime the right to the use and occupation, rent free, of the home then occupied by him at 674 Elliott Drive, Pasadena, California, or some other home of similar rental value. The donor also excepted from the transfer, the right, subject to the discretion of the Board of Trustees, (1) to have $100.00 per month paid to J. R. Davenport, the brother of Levi M. Davenport, for his support and maintenance, and (2) also subject to the discretion of the Board of Trustees, a portion of the trust income for the care of any child of Levi M. Davenport who might "come to want." Neither the $400.00 per month nor any amount for the brother or children of Levi M. Davenport has ever been paid [Tr. 62, 64, 65, 150].

The trust was required to pay $300.00 per month to LaVerne College, a corporation, for the purpose of establishing a Department of Philosophy and Religion; at the discretion of the Board, $300.00 per year to the American Bible Society, New York City; such annuities as might be agreed upon between the Board of Trustees and the annuitants who might add to the trust, and all the rest and residue of the undistributed income was to be used by the Board of Trustees for religious, charitable and educational purposes consistent with purposes of the trust, as directed by the Board of Trustees. The trust indenture provided that the vacancies on the Board of Trustees of the trust should be filled as determined by the Elders Body of the Church of the Brethren of the District of Southern California and Arizona [Tr. 84-97].

Included in the properties transferred to the trust was the Davenport residence or home place at 674 Elliott Drive, Pasadena, California [Tr. 52]. It was later agreed by the Board of Trustees and the trustor that the Davenport home place had been transferred in trust by mistake and had not been intended to be a part of the initial trust [Tr. 53]. Accordingly, on or about March 26, 1940, the trustee reconveyed this property to the trustor, Levi M. Davenport [Tr. 53, 75, 113, 114].

Included in the properties conveyed to the trust was a parcel of real property known as the "First Street Property." After the trust had been created, the trustor and the Board of Trustees considered it advisable to make certain improvements on the First Street Property [Tr. 54-55]. The trustee was advised by its attorney that it could not borrow money for the benefit of the trust, but that it would be possible to convey the property back to the trustor, have him borrow the money, make the im-

provements and convey it back to the trust again [Tr. 55]. This plan was followed, the reconveyance to the trustor was made, the property was improved, and then conveyed to petitioner which had been incorporated in the meantime to take over the properties formerly held in the trust [Tr. 74, 110 to 113, incl.].

When the trust was created, it was not contemplated that the trust properties would be turned over to a special corporation until the death of the trustor [Tr. 96]. However, Levi M. Davenport was dissatisfied with the trust arrangement for two reasons—(1) he had been informed that the trustee could not borrow money to improve properties and (2) he had created the trust before he quite worked out his plans for arranging some little security for his daughter, other children and brother. He did not like the arrangement in the trust indenture whereby, within the discretion of the trustees, amounts could be paid to his brother and children in case of their want. Accordingly, the corporation was formed during the life of Levi M. Davenport to cure the undesirable features of the trust [Tr. 53 to 58, incl.].

Shortly after petitioner was formed, namely, on October 8, 1940, LaVerne College, as trustee, transferred to petitioner all the real and personal property which it then held under and by virtue of the trust created by Levi M. Davenport and Barbara N. Davenport, his wife [Tr. 75, 135 to 138, incl.].

On or about May 31, 1941, Levi M. Davenport and his wife transferred to petitioner the Davenport "home place" [Tr. 76, 139]. Contemporaneously therewith petitioner and the tranferors executed an annuity agreement whereby (a) the transferors retained the right to use the home place for their lives, (b) petitioner agreed to pay

Lucile Davenport Weller, transferor's daughter, an annuity of $100.00 per month and upon her death, to pay to her daughter, Dorothy May Weller, a conditional annuity of $100.00 per month. Petitioner's obligation to pay such annuities was absolute and not dependent upon whether petitioner had net income or net earnings. The annuity to Dorothy May Weller was to be reduced under certain conditions not now material [Tr. 131 to 148, incl.]. Levi M. Davenport and his wife continued to live in the home place throughout the remainder of their lives, petitioner paying the taxes and other expenses of upkeep of its property [Tr. 77, 78]. Barbara N. Davenport died in November, 1943, intestate [Tr. 60, 68]. Levi M. Davenport died January 6, 1947, intestate [Tr. 81].

On or about May 31, 1941 Levi M. Davenport and his wife transferred to petitioner the aforementioned First Street property subject to a reservation whereby Levi M. Davenport received the net income from such property for his life and subject to an exception from the transfer of the right to designate in writing during his lifetime the disposition of such net income for a period not to exceed ten years after his death [Tr. 139 to 142, incl.]. Levi M. Davenport thereafter received directly the rent from such property and paid the taxes thereon [Tr. 77]. Petitioner paid certain expenses of upkeep as follows:

1940	$ 8.62
1942	63.02
1943	350.70
1944	1,297.78

If and to the extent that Levi M. Davenport should have paid such expenses, petitioner will offset such amounts against moneys owing him [Tr. 63].

The right of Levi M. Davenport to receive the net income of the "First Street Property" for life was in lieu of, and cut off, his right set out in the original trust indenture to receive $400.00 per month for life [Tr. 55, 58, 63, 64, 65].

Levi M. Davenport considered and intended that the arrangements made on May 31, 1941, for his daughter, Lucile M. Davenport, in the form of $100.00 annuity and the reservation by him of the right to designate the income from the "First Street Property" for ten years after his death, was to be in lieu of and a substitute for the provisions in the trust indenture whereby the trustees might, in their discretion, pay amounts to the brother and children of Levi M. Davenport in case any of them might "come to want" [Tr. 55 to 59, incl.]. Many years prior to the creation of the trust Levi M. Davenport had given $35,000.00 to each of his two sons and they had proceeded to create some property values and income for themselves and had such a financial standing that they were not likely to be in need of help from their father or his trust or petitioner. Levi M. Davenport had given his daughter, Lucile Davenport Weller, much less than $35,000.00 and hence the provision in the trust indenture that the trustees could in their discretion give something to his children in case of want. It was his daughter he was particularly concerned about [Tr. 53]. In forming the corporation he wished to make more definite arrangements for his brother and to cut off or terminate the indefinite arrangements set out in the trust indenture [Tr. 58]. Accordingly, he made the provision of a $100.00 annuity for his daughter and kept it within his power to arrange for his brother and other children if necessary or desirable by virtue of his right to designate the income from the "First

Street Property" for ten years after his death. However, Levi M. Davenport did not during his lifetime make any such designation of the "First Street Property" to take effect after his death [Tr. 58, 60, 69, 70]. His brother, as well as his sons and daughter, had adequate financial resources of their own [Tr. 67 to 71, incl.].

In 1940 petitioner paid $1,000.00 to Lucile Davenport Weller, daughter of the donor, and in 1941 paid $625.00 to Homer Davenport, the son of the donor, in satisfaction of their claims against the assets which the donor transferred to petitioner and its predecessor [Tr. 78]. Practically all of the assets which went into petitioner and its predecessor had been in a corporation called L. M. Davenport Company. Lucile Weller had stock of a par value of $1,000.00 in such company and Homer Davenport had stock of a par value of $625.00 in such company. The L. M. Davenport Company was dissolved and the assets deeded to Levi M. Davenport, subject, however, to the claims of the two minor stockholders. Levi M. Davenport deeded the property to the trustee subject to such claims and the trustee deeded it to petitioner subject to such claims and eventually the claims were paid by petitioner [Tr. 66-70, incl.].

Neither petitioner's Articles of Incorporation nor By-Laws authorize it to distribute income to private individuals [Tr. 118, 124 to 134, incl.], although it is authorized to accept property subject to such conditions and limitations as may be imposed by the donor in connection with property so acquired [Tr. 115, 133].

During the years involved petitioner made contributions to religious, charitable or educational organizations exempt from Federal income tax under Section 101(6) of the Internal Revenue Code, in amounts aggregating $20,-

124.09. This included the organizations listed on page 79 of the transcript, total $19,881.09 and those listed in items 3, 4 and 6 on page 80 of the transcript, total $243.00 [Tr. 63, 64, 65, 72]. (The 1943 contribution to Radio Gospel Hour was $50.00 instead of $5.00, as shown on page 80.) During the same years it made contributions to religious, educational and charitable organizations for which no known exemption from income tax has been granted, as follows [Tr. 71 80]:

	1941	1942	1943	1944
United American Defense Committee	$25.00			
National Voice		$15.00	$15.00	$35.00
W. M. Miles Radio Program				10.00
State-Wide Committee, Higher Education				2.00
Los Angeles Times		24.50		
	$25.00	$39.50	$15.00	$47.00
Total				$126.50

In each of the years under review petitioner paid $10.00 to the Property Owners Association of Los Angeles, California, an organization exempt under Section 101(8) of the Internal Revenue Code. That organization assists taxpayers in keeping down the local taxes and petitioner made the contribution to that organization for the purpose

of trying to keep down the taxes on its property [Tr. 64, 81].

Levi M. Davenport, as founder of petitioner, generally directed its affairs during his lifetime. He caused petitioner to make contributions to organizations which were not exempt under Section 101(6) of the Internal Revenue Code as follows [Tr. 80]:

	1940	1941	1944
Democratic Club for Wilkie, Los Angeles	$14.18		
Jeffersonian Democrats, Los Angeles	10.00	$25.00	
Republic Club, Los Angeles, Cal.			$25.00
Democrat Club, Los Angeles, Cal.			25.00
	$24.18	$25.00	$50.00
Total			$99.18

Petitioner intends to charge Levi M. Davenport for such unauthorized contributions by withholding amounts owing to him [Tr. 63].

The only other amounts paid out by petitioner during the years involved were for business expenses which have been allowed as deductions by the respondent [Tr. 150].

Specification of Errors Relied Upon.

1. The Tax Court erred in failing to find that the provisions made for the grantor and his family amounted to reservations and exceptions from the properties transferred to petitioner and its predecessor.

2. The Tax Court erred in failing to find that some of the provisions of the predecessor trust made for members of the grantor's family were discretionary provisions and were cut off when petitioner was organized.

3. The Tax Court erred in failing to find that in any event the members of petitioner's family were in such financial condition that they did not and were not likely to, call upon petitioner for financial assistance.

4. The Tax Court erred in failing to find that if petitioner, under the management of the grantor, made any improper payments, petitioner will recoup such payments from the grantor by withholding moneys due him or by claims against his estate.

5. The Tax Court erred in failing to find that payments made by petitioner to two of grantor's children were in discharge of claims held by such children against the petitioner's assets.

6. The Tax Court erred in failing to find that certain payments to several organizations were for religious, educational and charitable work or were business expenses of petitioner.

7. The Tax Court erred in failing to find that petitioner was exempt from income and declared value excess

profits tax for the years 1940 to 1945, inclusive, under the provisions of Sections 101(6), 600, 1200 and 1201(a)-(1) of the Internal Revenue Code.

8. The Tax Court erred in holding that petitioner distributed some of its income to organizations or persons not exempt from tax.

9. The Tax Court erred in holding that petitioner was not exempt because it did not distribute, during the taxable years, the entire amount of its income.

10. The Tax Court erred in failing to find that petitioner was exempt from income and declared value excess profits taxes for the years 1940 to 1944, inclusive, under the provisions of Sections 101(14), 600, 1200 and 1201-(a)(1) of the Internal Revenue Code.

11. The Tax Court erred in rendering decision for the respondent.

Statutes Involved.

Section 101 of the Internal Revenue Code exempts from income tax certain corporations. The applicable paragraphs read as follows:

Section 101(6) of the Internal Revenue Code reads as follows:

> "(6) Corporations, and any community chest fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or

individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation";

Section 101(14) of the Internal Revenue Code reads as follows:

"(14) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this chapter";

Summary of Argument.

While petitioner received the legal title to all the properties conveyed to it, it did not receive the entire *fee interest* in such properties. It received only the remainder after certain reservations in favor of the grantor and after certain exceptions in favor of members of the grantor's family. *Petitioner's* entire interest in the property, as distinguished from interests reserved for others, was to be, and has been, devoted exclusively to religious, educational and charitable purposes.

The use by the Davenports of the Davenport home, the collection of the income from the "First Street Property" by Levi M. Davenport and the receipt by Lucile Weller of the $100.00 annuity did not constitute the receipt by them of part of *petitioner's* income, as such items were never a part of petitioner's assets or income but were always properties and rights reserved from property transferred to petitioner.

The provisions in the original trust for payment of $400.00 per month to Levi M. Davenport out of the income of the trust and a contingent and discretionary payment to his brother and children was cut off and terminated, by other and substitute provisions, when petitioner was incorporated.

The $1,625.00 paid by petitioner to the donor's children was in satisfaction of claims they had against the assets transferred to petitioner subject to such claims.

Petitioner's income was either accumulated for improvement of the properties or expended for ordinary business expenses or distributed to religious, educational or charitable organizations, most of which had been held exempt from income tax. Very small amounts were paid out for unauthorized expenditures such as contributions to political organizations but these expenditures will be recouped by petitioner by withholding amounts payable to the donor.

Thus petitioner is and was a corporation organized and operated exclusively for religious, charitable and educational purposes, no part of the net earnings of which inured to the benefit of any private individual and no substantial part of the activities of which was carrying on propaganda or otherwise attempting to influence legislation and hence was exempt under Section 101(6) of the Internal Revenue Code.

In the alternative, petitioner was exempt under Section 101(14) of the Internal Revenue Code because it was a corporation organized for the exclusive purpose of holding title to property, collecting income therefrom and turning over the entire amount thereof, less expenses, to organizations which themselves were exempt from the tax imposed by this chapter. The fact that taxpayer accumulated some of its earnings for improvement of its properties does not deprive it of exemption under this paragraph as such income will eventually be used for the statutory purposes. The minor contributions to charitable, religious and educational organizations which apparently have not obtained exemptions from income tax should be ignored under the *de minimis* rule.

Petitioner's own assets and income, exclusive of life estate and other reserved interests, were to be used and were used solely for religious, charitable and educational purposes and no part of petitioner's own assets and income was used or was to be used for payments to Levi M. Davenport or any member of his family.

The authorities are in complete agreement that the reservation by a donor of an interest in property or an annuity does not affect the exemption of a charitable organization which receives a gift. The Tax Court conceded this point but erred in failing to find that all of the amounts which went to individuals were received by them by virtue of reservations and exceptions in the transfers to petitioner.

ARGUMENT.

Petitioner Is Exempt From Tax Under Section 101(6) of the Internal Revenue Code.

It is admitted by both the respondent and the Tax Court that petitioner was a non-profit California corporation organized to act as trustee under Christian educational, charitable, eleemosynary and other charitable trusts and that it had no provisions for distributing its income to anyone.

It has also been stipulated that most of its income during the years involved was paid out as contributions to religious educational and charitable organizations which were exempt from income tax.

The controversy arises over the fact that with respect to some of the properties to which petitioner held legal title (a) the donor had the right to use one piece and was entitled to receive the income from another, (b) the donor's daughter was entitled to an annuity of $100.00 per month for her life, with a contingent annuity for the life of her daughter, (c) there is disagreement as to whether some of the income might be used for the donor's brother and children, (d) minor amounts were paid for the upkeep of one of petitioner's properties which possibly should have been paid by the donor, and (e) minor contributions were made to political organizations for which petitioner is entitled to recoupment.

It is the petitioner's position that anything that was used or received or retained by the donor and his family came by way of a reservation or exception from the grant

of property to petitioner, and the receipt by the donor and his family did not constitute a receipt of *petitioner's* income, as such property or income never became petitioner's property or income. This matter will be discussed first and the other points will be taken up thereafter.

(A) The Reservation, by a Donor of Property to an Otherwise Exempt Corporation, of an Interest in Property or an Annuity Payable to the Donor or Others, Does Not Destroy the Exemption of the Donee.

The leading case to the effect that the reservation by a donor of an interest in property or an annuity does not affect the exemption of a charitable organization which receives the gift is *Lederer v. Stockton,* 260 U. S. 3. In that case a decedent had devised property to a charitable corporation subject to the payment of certain annuities. The Supreme Court held that the payment of annuities did not destroy the exemption of the charitable corporation and on page 8, the Court said:

> "This residuary fund was vested in the Hospital. The death of the annuitant would completely end the trust. For this reason, the trustee was able safely to make the arrangement by which the Hospital has really received the benefit of the income subject to the annuity. As the Hospital is admitted to be a corporation whose income when received is exempt from taxation under Section 11(a), we see no reason why the exemption should not be given effect under the circumstances. To allow the technical formality of the trust, which does not prevent the Hospital from really enjoying the income, would be to defeat the beneficient purpose of Congress."

One of the clearest statements of the applicable law is set forth in *Emerit E. Baker, Inc. v. Commissioner,* 40

B. T. A. 555, Acq. 1940-1 C. B. 1. There taxpayer was organized in 1924 as a non-profit charitable corporation. Its principal organizer was Emerit E. Baker. The taxpayer operated for charitable purposes under the direction of Emerit E. Baker and six of his associates. In 1929, Emerit E. Baker died, leaving a will appointing the taxpayer as executor and trustee of his residuary estate. The will provided that the taxpayer, as trustee of the residuary estate, should pay decedent's wife an annuity of $12,000.00 a year, which should be paid out of the trust corpus if the income should be insufficient. The will also provided for the continuance of payments for the education of any pupils in school being maintained by the decedent at the time of his death. It then provided that any additional income be used for certain specific charitable purposes to aid the City of Kewanee, Illinois, the purposes of which were essentially similar to those for which the taxpayer was formed. Decedent's widow, in lieu of asserting her dower right, agreed to accept an annuity from taxpayer of $19,200.00 per year or $7,200.00 per year more than was provided in the will. The Commissioner assessed deficiencies against taxpayer on the basis that it was not an exempt corporation because of the annuity paid to decedent's widow and other payments made for the educational expenses of certain of the widow's nieces and nephews who were being helped by decedent at his death.

The Board of Tax Appeals held that the taxpayer was an exempt corporation by reason of its charitable nature. With respect to the Commissioner's contentions regarding the annuity and other payments, the Board at page 561 said:

> "Petitioner's only activity during the taxable years which was not strictly of a charitable or educational

> character was the payment of the allowance to the decedent's widow and the educational expenses of her nieces and nephews. We do not think that that alone defeats its classification as an exempt corporation under the statute. The payment of these amounts was merely incidental to and was a means of furthering the charitable and educational purposes for which the petitioner was organized. It was in no sense a part of its corporate activities. The payments made to the widow and nieces and nephews were a charge not upon the petitioner's net earnings but against the entire corpus of the residuary estate."

In *Estate of J. B. Whitehead v. Commissioner,* 3 Tax Ct. 40, affirmed 147 F. (2d) 977, the same rule was announced. In that case tht decedent left his entire estate subject to certain special bequests to a charitable foundation to be formed after his death. The will provided that certain settlement contracts with a former wife and his wife at the time of death, be carried out, and also provided for the payment of two annuities of $5,000.00 and $7,500.00 per year, respectively, to two individuals. The taxpayer in that case paid the widow $500,000.00 in settlement of her claim for the entire estate. The Commissioner refused to allow the decedent's estate to deduct from the gross estate the amounts paid to the charitable foundation, on the ground that the charitable foundation did not qualify as an exempt corporation. The Tax Court in holding that the corporation was a charitable one and that the payments were deductible, said:

> "To hold that discharge of such claims against an estate as those of the widow, and the former wife, based upon law or contracts and payable in any event, destroys a broad testamentary provision that the *residuum* of the estate go to charity would, no doubt,

> tend to strike down very many testamentary charities, for it can hardly be thought that an estate would have no claims against it at all."

The United States Circuit Court of Appeals for the Fifth Circuit, in affirming the Tax Court's decision, said:

> "We find it sufficient to say that the terms of the will, the facts surrounding its execution and administration, and the condition of the estate at testator's death, leave us in no doubt that his purpose to create a charitable trust, to devise to it, subject only to the payment of its known debts for which he had ample cash on hand, all of his property, and, subject to the payment out of it of certain small bequests, to dedicate and devote the entire income therefrom to charitable uses, has been sufficiently indicated and must be given effect."

To the same effect, see *Pasadena Methodist Foundation v. Commissioner,* Tax Ct. Memorandum Decision, Docket No. 109667 and 109668, entered October 11, 1943, C. C. H. Decision 13, 544M; *Home Oil Mill, et al v. Willingham,* 68 Fed. Sup. 525, appealed by government, dismissed on government's motion January 9, 1947, Prentice-Hall Fed. Tax Service, paragraph 72304. See also I. T. 1776, C. B. II-2, 151; I. T. 3707, C. B. 1945, 114; I. T. 2397, C. B. VII-1, 90; and G. C. M. 3016, C. B. VII-1, 90.

Petitioner's claim for exemption in the present case is supported by several rulings of the Bureau of Internal Revenue. Thus, in I. T. 1776, C. B. II-2, 151, it was

held, under the Revenue Act of 1921, that where a donor gave a life estate in bonds to an individual and the remainer interest to a church, the cash value of the gift to the church was deductible. In I. T. 3707, C. B. 1945, 114, it was held that where a taxpayer creates an irrevocable trust, reserving the income to himself for life with remainder over at his death to a beneficiary which meets the requirements of Section 23(o)(2) of the Internal Revenue Code, the present value of the remainder interest is deductible as a charitable contribution. In I. T. 2397, C. B. VII-1, 90, it was held that where taxpayer transferred $50,000.00 to a college upon an agreement that he should receive an annuity of $2,500.00 per annum, the difference between the $50,000.00 and the present value of the annuity was deductible as a charitable contribution under Section 214(a)(10) of the Revenue Act of 1926. In G. C. M. 3016, C. B. VII-1, 90, it was held that where, upon the death of the survivor of two life beneficiaries, the principal of a trust fund was to be paid to an agency organized and operated exclusively for charitable, scientific or educational purposes, the present value of the remainder interest was deductible under Section 214(a)(10) of the Revenue Act of 1926.

Since reservations by donor to an otherwise exempt corporation did not destroy its exemptions, there remains the problem of determining which of the payments to the donor or his family in the instant case were required by reservations.

(B) All the Payments to Be Made by Petitioner to Donor and His Family Were Required by Reservations and Exceptions From the Properties Contributed to Petitioner by Donor.

When Levi M. Davenport transferred properties to the trustee he transferred them with the following reservations for himself; (1) $400.00 per month during the term of his natural life; (2) the right to live in the Davenport home, rent free, during his life.

He also made an exception from the property transferred to the trustee in the form of a provision for his brother and children should they "come to want," at the discretion of the Board of Trustees.

The Davenport home and the "First Street Property" were conveyed by the trustees back to Levi M. Davenport and were in his hands at the time petitioner was created. Petitioner received the remainder of the property in the trust subject to the terms of the trust.

On May 31, 1941, Levi M. Davenport transferred the Davenport home and the "First Street Property" to petitioner in such manner as to affect and change all the reservations and exceptions upon which the property had originally been transferred to the trust.

With respect to the Davenport home, he reserved the right for the life of himself and his wife, Barbara N. Davenport, to live in the home. At the same time he excepted from the grant of the Davenport home to the petitioner, an annuity of $100.00 per month payable to his daughter and upon her death a conditional annuity of $100.00 or $50.00 per month payable to her daughter. This latter provision satisfied Levi M. Davenport that his daughter would have some security and he intended that this provision would terminate the provision in the trust

whereby the trustees might, at their discretion, pay something to his daughter in case of her want.

Also on May 31, 1941, Levi M. Davenport deeded the "First Street Property" to the petitioner but reserved for himself the right to receive the net income from this property for his lifetime. This provision was intended to and did terminate his right to receive $400.00 per month, provided for in the original trust indenture. He also excepted from said deed to the petitioner the right to designate in writing, during his lifetime, the disposition or use of said net income for a period not to exceed ten years after his death. This latter provision was intended by Levi M. Davenport to be in lieu of and to terminate the right and power of the trustees, in their discretion, to give some of the trust income to petitioner's other children or brother in case of their want.

Consequently, all of the rights remaining in or going to the grantor and his family were created by reservations or exceptions from the deeds of property to petitioner or its predecessor. As a matter of law, therefore, none of those rights ever belonged to petitioner, *Blair v. Commissioner,* 300 U. S. 5; *Estate of Homer Laughlin,* 8 T. C. 33. Petitioner received the balance only of the interests in the properties deeded to it. The grantor reserved some of those interests for himself and excepted from the deeds interests in favor of others. These interests reserved and excepted were, therefore, excluded from the operation of the deeds or grants and were never in petitioner. Consequently, when petitioner allowed the grantor to use the home or to receive the income from the "First Street Property" and when petitioner paid the annuity to grantor's daughter, it was not paying out its own income or money but simply turning over to those persons their

own property or money which never was the property of petitioner.

The respondent argues that the provision in the original trust indenture whereby the brother and children of the donor might, in the discretion of the trustees, receive some of its income in case of their want, has not been cut off by the agreements of May 31, 1941 and are so indefinite and uncertain that they might take up all of the net income of petitioner and hence the petitioner was primarily organized for private and not for charitable purposes.

The testimony showed that it was the belief and intention of the grantor that the annuity provided for the daughter, and the right in the grantor to dispose of the income of the "First Street Property" for ten years after his death, were to take care of his brother and children and were to cut off the previous rights in their behalf. The testimony also showed that the brother and children were in good financial condition and were not likely to call upon the petitioner for help. Furthermore, the directors of petitioner would naturally assume that the terms of the original trust whereby they might pay something to the brother and children of the grantor had been changed by the May 31, 1941 documents since that was the intention of the grantor and the interpretation he put upon them.

Finally, if the provisions of the original trust still remain in effect after May 31, 1941, and if they are so uncertain and indefinite as indicated by the respondent, then such uncertainty renders the exceptions void. Uncertainty which renders exceptions void accrues to the benefit of the grantee and does not invalidate the entire grant but merely leaves it free and clear of the exceptions. See 26 Corpus Juris Secundum, page 457. Therefore, under the respond-

ent's own argument, petitioner is free of any requirement to distribute money to the grantor's brother or children.

The Tax Court has recognized that the reservation by the grantor of the right to use the Davenport home and the right to the income of the "First Street Property" was a reservation and does not deprive the petitioner of its exemption. The Tax Court on this point said:

> "If the 'First Street Property' and the home property which were transferred to the petitioner, subject to reservations, were the only properties here involved, similarity of the cases might prevent their distinguishment." [Tr. 41.]

Petitioner submits that the use of the Davenport home and the use of the income from the "First Street Property" were reserved by the donor and such interests never belonged to the petitioner and hence were never paid out by Petitioner from its property or income to private persons.

The same is true with respect to the annuity to the daughter. This was an exception from the grant to petitioner and the $100.00 per month never was petitioner's property or income and hence when petitioner paid it out to the grantor's daughter, such act did not amount to a distribution of petitioner's income to private parties and hence does not destroy petitioner's exemption.

With respect to the provisions for the brother and children of grantor, it is petitioner's position that (1) the provisions in the trust indenture were cut off by the documents and transfers of May 31, 1941, (2) if the trust provisions were not so cut off they are immaterial, as the children and brother will never need to call upon petitioner, (3) if the brother or children do call upon petitioner,

petitioner will consider that their rights were cut off as was intended by the grantor and will exercise its discretion to deny their request, (4) even if the rights still subsist and if payments are made to the brother or children, they will have been made by virtue of exceptions made by the grantor when he transferred the property to petitioner and its predecessor. Hence, the amounts disbursed to the brother and children would not be disbursements of petitioner's property or money but disbursements of property or money reserved or accepted from the grant and never belonging to petitioner.

This brings us now to the final item which was paid to members of petitioner's family, namely, the $1,000.00 to the daughter and the $625.00 to the son. Here again, these amounts were not petitioner's property or money paid out but were the property of the claimants.

The donor, Levi M. Davenport, owned most of the stock of the L. M. Davenport Company. His daughter and son had stock interests of $1,000.00 and $625.00, respectively, therein. That company was dissolved and its assets deeded to Levi M. Davenport, but he took the property for himself and as trustee for the other stockholders who had claims against such property and were owners of portions thereof. Levi M. Davenport then deeded the property to the trustee, but, of course, deeded it subject to liens, encumbrances, or trusts outstanding against it. Petitioner took only such interest as the grantor had and took it subject to the condition of the title. Eventually the petitioner paid the daughter and the son the $1,000.00 and the $625.00, respectively, for their interests in the property and their claims against it.

Here, again, petitioner was merely turning over to other people, their property which had been placed in petitioner's

hands. This does not amount to a distribution of petitioner's property or petitioner's income to private persons, as it never was petitioner's money or income.

Hence, any rights or moneys which donor or his family received or might receive from petitioner were required by reservations and exceptions from the deeds transferring the property to petitioner and were not distributions of petitioner's money or income and do not deprive petitioner of exemption.

By the time this case was tried in the Tax Court, Levi M. Davenport and his wife, Barbara N. Davenport, had both died. Levi M. Davenport had not appointed the income of the "First Street Property" for any period after his death. As a consequence, out of the $270,000.00 worth of property which they transferred to petitioner and its predecessor the following is all that the grantor and his family received or will ever receive:

1. The use of the Davenport home for about 7½ years (May 23, 1939 to January 6, 1947),
2. The income from the "First Street Property" for about 5½ years (May 31, 1941 to January 6, 1947),
3. An annuity of $100.00 per month from May 31, 1941, for the daughter who was born on May 20, 1893, and hence was 53 years old at the time of the trial, and a conditional annuity for a younger woman who probably will never take anything under it.

The rental value of the home was $1,500.00 per year, making the total for 7½ years $11,250.00, and the net income of the "First Street Property" was $4,800.00 per year, a total of $26,400.00 for the 5½ years. The reservations of these up to the date of the trial amounted in

value to but $37,650.00, a small portion of the value of the property granted to petitioner. The annuity of $1,-200.00 per year to the daughter is equal to but a small fraction of the net income of petitioner, which averaged, before any contributions were made to charity, something over $9,000.00 per year. The total amount the daughter would receive from May 31, 1941, until the end of her life expectancy would be about $26,000.00.

Thus the total amount paid or likely to be paid to the grantor and his family would hardly exceed $63,650.00, leaving to petitioner at least $206,000.00 and the income therefrom for religious, charitable and educational work.

It would scarecly seem, therefore, that the petitioner was organized more for private than for charitable purposes. Grantor gave at least three-fourths of all his property for charitable, religious and educational purposes and retained only one-fourth for himself and family.

The grantor's action was certainly charitable and it is prayed that minor informalities or defects in the beneficent plan be judged with equal charity.

(C) All of Petitioner's Authorized Contributions Were Made for Charitable, Religious and Educational Work.

As seen by the provisions of the trust indenture, the grantor obviously believed in extending education in religious matters. He provided that the trustees should pay to the LaVerne College $3,600.00 per year for the purpose of establishing a Department of Philosophy and Religion. He also provided that the trustees could, in their discretion, pay $300.00 per year to the American Bible Society and such other amounts for similar purposes as the trustees should decide upon.

Levi M. Davenport, as the creator of the trust and the donor of the property to petitioner, was the dominant power in the operation of petitioner throughout his life. His deeply religious nature led him to cause petitioner to make contributions for various educational, religious and charitable purposes. On page 79 of the Transcript is shown the contributions made by petitioner during the years involved. They include amounts to the LaVerne College, Los Angeles Tuberculosis & Health Association, the various War Chests, American Red Cross, Children's Home Society, American Bible Society, United China Relief, Boys Clubs, American Mission to Lepers, Church of the Brethren and various religious radio programs. All of the institutions shown on page 79 and those listed as items 3, 4 and 6 on page 80 of the Transcript, were organizations which had obtained exemption from income tax because of their charitable, religious and educational work. The bulk of petitioner's net income went to such organizations. Some of its income it retained for improvement and enlargement of its properties, which resulted in an increase in its income. See Transcript 149 and 150.

In addition to the contributions to organizations for which tax-exemption certificates had been granted, petitioner also made similar contributions to other religious, educational and charitable organizations for which no known exemption from income tax has been granted. These were as follows:

United American Defense Committee.
National Voice.
W. N. Miles Radio Program.
State Wide Committee, Higher Education.
The Los Angeles Times.

All of these organizations carried on work of a religious, charitable or educational nature. As to the National Voice, testimony showed that its work was religious education. In any event, it is clear that the work of all was of a religious, charitable and educational nature, of a type which petitioner was permitted to assist and still be exempt from income tax.

(D) Petitioner Is to Be Repaid for Any Expenditures Made for Unauthorized Purposes.

Levi M. Davenport was an aged man, born August 4, 1861. He was 78 years of age when the trust was created. Being the sole contributor of the trust, it was natural that he would dominate its benefactions. Not being tax minded, it was natural that the trust would be run with informality and that he might make some contributions to organizations which did not technically qualify under Section 101(6) or 101(14) of the Internal Revenue Code.

Mr. Davenport caused petitioner to make contributions to Republican and Democratic Clubs during the 1940 and 1944 national campaigns in a total amount under $100.00. Since he contributed to both parties it would appear that his purpose was more educational than political.

Under the original trust indenture Levi M. Davenport was to receive $400.00 per month for life. Under the agreement of May 31, 1941, he was to receive the net income of the "First Street Property" for his life. The rental value of this property was $5,400.00 per year and the taxes amounted to about $600.00 per year, leaving a net of $4,800.00 per year. Levi M. Davenport considered that the net income from the "First Street Property" was equal to the $400.00 per month he was to receive under

the original trust indenture and he took the second provision in place of the first. After May 31, 1941, he never requested or received the $400.00 per month provided for in the original trust agreement.

Levi M. Davenport directly collected from the tenant the rent from the "First Street Property" and paid the taxes thereon. He considered that this was all he was required to do. Petitioner paid other upkeep expenses of the property aggregating in the taxable years $1,720.12. The grantor interpreted the term "net income" as meaning the gross rent less the taxes. If another interpretation of the term "net income" would have required him to pay the upkeep of the property, then he has caused petitioner to pay out money which it should not have paid, for his benefit. If that is the final interpretation of the directors, they have testified that they would withhold from moneys owing him, the amount of such unauthorized expenditures so caused to be made by petitioner.

The Tax Court seems to think [Tr. 42], that the petitioner should not have paid the taxes and maintenance expenses on the Davenport home while it was occupied by Levi M. Davenport. Petitioner does not agree with this interpretation as, under the agreement of May 31, 1941 [Tr. 139-141], donor and his wife transferred the home property to the petitioner "subject to the right of the donors and the survivor of them to the use thereof for and during the term of their and each of their natural lives." Since the remainder interest in the property belonged to petitioner, naturally it had to pay the taxes and upkeep in order to protect its interests. The donor and his wife were entitled to the use of the house, rent free, with expenses paid by petitioner. It is believed that petitioner was required by the terms of the contract to pay

the taxes and upkeep expenses and that the payment thereof by petitioner did not constitute a distribution of petitioner's income to the donor or his wife. If Levi M. Davenport was supposed to pay such taxes and upkeep on the home, then petitioner will recoup itself out of moneys owing to him or out of his estate.

II.

In the Alternative Petitioner Was a Corporation Organized for the Exclusive Purpose of Holding Title to Property, Collecting Income Therefrom and Turning Over the Entire Amount Thereof, Less Expenses, to an Organization Which Itself Is Exempt From Income Tax.

If the Court holds that petitioner was not exempt from income tax under the provisions of Section 101(6) of the Internal Revenue Code, then it is submitted that petitioner is exempt from tax under the provisions of Section 101(14) of the Internal Revenue Code.

After excluding from consideration payments required to be made by petitioner by virtue of reservations and exceptions in the deeds and grants from the donor to petitioner of various parcels of property, all of petitioner's authorized contributions were made to organizations exempt from income tax. In G. C. M. 11,817, C. B., June, 1933, page 56, the respondent conceded that the right to exemption from Federal income tax under Section 101-(14) of the Internal Revenue Code is not defeated where a holding corporation pays its income to several organizations, each of which is entitled to exemption.

As shown heretofore in this brief, all of the rights and benefits which the grantor and his family received or retained were reserved to them or retained as exceptions

in the deeds and transfers made to petitioner. Hence, those rights and benefits were never petitioner's property or income and hence were not distributed by petitioner to such private persons. Only the excess over and above the amounts reserved or excepted from the deeds, were petitioner's property and that is all for which petitioner needs to account.

The contributions which petitioner made from its own property and income were made to organizations exempt from income tax. This point has been discussed in a preceding portion.

Petitioner did make a few contributions to charitable, religious and educational organizations for which no known exemption from income tax has been granted. It paid out during the years involved $20,124.09 to organizations for which exemption had been granted and $126.50 to religious, educational and charitable organizations for which no known income tax exemption has been granted.

The $126.50 paid to religious, charitable and educational organizations for which no known income tax exemption has been granted, should be ignored under the doctrine of *de minimis*. Those organizations probably can secure exemption or may even have it but petitioner was unable to determine whether or not exemption had been granted to them. The amount involved is so small as compared with the total benefactions that they should not be allowed to deprive petitioner of its exemption.

The amounts paid each year to the Property Owners Association of Los Angeles, California do not tend to deprive petitioner of exemption as the Property Owners Association was exempt from income tax under the pro-

visions of Section 101(8) of the Internal Revenue Code. It, therefore, qualifies under Section 101(14).

Here, again, if petitioner made any unauthorized distributions, whether to political clubs or on property the maintenance of which might have been payable by the donor, this will not tend to deprive petitioner of exemption, as it is entitled to and will receive recoupment from the donor for these expenditures.

The fact that petitioner might have accumulated some of its income for the enlargement or improvement of its properties does not deprive it from exemption under Section 101(14) of the Code, as all of its income must eventually be turned over to tax exempt organizations and that is all that the statute requires. It does not require that it turn it over currently or annually, but only eventually.

III.

Petitioner Is Exempt From Declared Value Excess Profits Tax.

Petitioner has shown that it is exempt from Federal income tax under either Section 101(6) of the Internal Revenue Code or Section 101(14) thereof. Section 600 of the Code imposes a declared value excess profits tax on corporations subject to capital stock tax under Section 1200 of the Code. Section 1201(a)(1) of the Code provides that the capital stock tax imposed by Section 1200 shall not apply to corporations enumerated in Section 101 of the Code. Accordingly, petitioner is exempt from declared value excess profits tax.

Summary.

On the basis of the law and the facts, it is submitted that petitioner is exempt from Federal income tax under Section 101(6) of the Internal Revenue Code or under Section 101(14) of the Code; and that petitioner is exempt from declared value excess profits tax under Sections 600, 1200, 1201(a)(1) of the Code.

Respectfully submitted,

Melvin D. Wilson,
Counsel for Petitioner.